Director of
Central
Intelligence

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Implications of Mexico's Financial Crisis

Special National Intelligence Estimate

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IMPLICATIONS OF MEXICO'S FINANCIAL CRISIS

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THE NATIONAL FOREIGN INTELLIGENCE BOARD CONCURS.

The following intelligence organizations participated in the preparation of the Estimate:

The Central Intelligence Agency, the Defense Intelligence Agency, the National Security Agency, and the intelligence organizations of the Departments of State, the Treasury, and Energy.

Also Participating:

The Assistant Chief of Staff for Intelligence, Department of the Army

The Director of Naval Intelligence, Department of the Navy

The Assistant Chief of Staff, Intelligence, Department of the Air Force

The Director of Intelligence, Headquarters, Marine Corps

The Department of Commerce

SCOPE NOTE

This Estimate examines Mexico's financial crisis and the political and economic implications for both Mexico and the United States through the first six months of the de la Madrid administration. It does not address the implications of the crisis for the stability of the international financial system.

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25X1

KEY JUDGMENTS

Mexico is facing its most severe financial crisis in living memory, a crisis that could have grave implications for domestic political stability. Austerity measures needed to cope with the crisis will be shaped largely in response to the demands of the IMF and the international banking community. The government will be under strong pressure to cut public spending, restrain wages, and slash subsidies on food, fuel, and transport. These measures will inevitably:

— Go against nationalist tenets strongly held by all sectors of Mexican society.

— Strike additional blows against the already hard-hit interests of organized labor, a major component of the ruling party.

— Undermine living standards both of the middle class and of the very poor.

— Taint incoming president de la Madrid with an "antipopular" image, possibly casting a shadow over the next six years of Mexican political life.

Mexico faces a very bumpy period of adjustment to external demands and intense factional jockeying over economic issues in the next 90 days. A strong signal of this turmoil was Lopez Portillo's state of the union speech on 1 September. The nationalization of domestic banking—accompanied as it was by economically damaging but politically helpful rhetoric—reflects President Lopez Portillo's penchant for seeking scapegoats and avoiding harsh austerity measures. It will present considerable—but not necessarily insurmountable—problems for negotiations with the IMF.

Nevertheless, we believe that the new administration that comes to power on 1 December will give public support to an austerity program strong enough to satisfy the nation's creditors. The labor leadership will come around to supporting this plan in exchange for relatively minor concessions on wages and prices, but some wildcat demonstrations and strikes by labor rank and file may take place [redacted] 25X1 25X1 Economic growth will be negative during the period of the Estimate, and unemployment will reach record levels. Opposition parties of the left and right will attempt to make political profit from the crisis but will fail because of their shal-

25X1

low roots in Mexican society. Although the potential exists for spontaneous action and unorganized protests, widespread revolt is unlikely during the period of this Estimate. The Mexican political-economic system will survive in roughly its present form.

Most of the implications of the Mexican crisis for US interests are negative. Although we believe that US banks with loans in Mexico will get most of their money eventually, individual banks could be under considerable stress in the immediate future. US exports to the important Mexican market will fall sharply, and the economies of US border cities will be especially hard hit. The devaluations of the peso and the necessary austerity measures will strengthen both pull and push factors behind the flow of illegal migrants. On the more positive side, US owners of assembly plants in Mexico should see their exports and profits rise because of the devaluations.

The course of the Mexican crisis as already described is the most likely case. Any deviation from the scenario will probably be for the worse, not for the better. Recognizing that fact, we have included a "worst case" scenario describing how the present crisis could—but is not likely to—lead to a collapse of the Mexican system. We have also included a detailed checklist of indicators that should give the observer early warning of any change from the "most likely" scenario.

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DISCUSSION

Introduction

1. Mexico is in the midst of what its press describes as "the greatest crisis" since the Revolution of 1910. As of mid-August, two politically damaging devaluations in six months had failed to halt massive capital flight, foreign exchange reserves had fallen to only three days' import cover, foreign debt had reached a staggering $80 billion, and inflation had soared to almost 70 percent. The crisis comes at a time when the deepest recession since World War II has sharply increased already high rates of unemployment and underemployment and threatens numerous private firms, including some of the largest, with bankruptcy. Moreover, the crisis falls during the politically sensitive period between the election and the inauguration of a new president. As has been the case during past transitions, rumors of presidential "disappearances" and military coups are beginning to surface. Such rumors can be expected to continue and grow at least until 1 December, when President-elect Miguel de la Madrid is to take office.

2. At stake is the continuation of what has appeared to be one of the Third World's most successful and durable political-economic systems.[1] For more than half a century, Mexico has had stable governments and regular and orderly changes of administration. This long period of political stability—unique for a major Third World country—has been a major factor allowing economic growth to average between 6 and 7 percent since the mid-1930s—another unique achievement. A crumbling of the Mexican system would bring Third World instability to the US southern border, with all of the political, social, and economic problems that that implies for the United States. It would also have widespread political and economic repercussions in Latin America, and it would seriously unsettle the international financial system.

[redacted]

The Financial Crisis

3. While many factors have come together to create the current crisis, its roots are to be found in Mexico's 1976 economic crisis and President Jose Lopez Portillo's response to it. At that time, largely because of the ill-considered populist measures and antibusiness rhetoric of then President Luis Echeverria, Mexico was suffering large-scale capital flight and inflation had risen into the 20-percent range—high by Mexican standards. Echeverria responded by devaluing the peso in September and again in October—Mexico's first devaluations since 1954. The effect was traumatic politically and, because of the manner in which the measure was applied, of little immediate help economically.

4. Lopez Portillo, taking office in December 1976 with a reputation for economic competence, made politically unpopular austerity his first priority. Early in his administration he established a plan calling for two years of retrenchment, two years of "consolidation," and two years of rapid growth. Labor was called upon to accept several years of declining real wages with the understanding that the losses would be made up in the last two years of the six-year presidential term. With the rapid expansion of oil revenues, the plan worked even better than expected. From 1978 through 1981 economic growth averaged better than 8 percent. Unfortunately, this led Lopez Portillo to overcome his natural caution and expand his horizons. In the late 1970s, intoxicated by seemingly endless increases in oil earnings and with international bankers only too eager to make large loans to Mexico at favorable rates, Lopez Portillo established his "global plan" to transform Mexico's economy and society by the end of the century.

5. Although world recession and declining oil prices in the early 1980s made his dream impossible, Lopez Portillo refused to recognize that fact; there were signs as early as mid-1981 that his strategy was coming apart. Driven in part by the promises he had made to labor and to the Mexican people, he continued to increase government spending and borrowing. He was

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determined that his administration, which had begun in austerity, would end in growth and prosperity. Thus, he waited far too long to take the actions that might have avoided or mitigated the crisis. And those reluctant actions that he did take—such as the February 1982 devaluation followed by sharp wage increases—were contradictory and only added to the fears of sophisticated Mexican and foreign investors. Loans became increasingly difficult and capital flight intensified.

6. The crisis came to a head in early August. A second major devaluation on 6 August failed to halt massive capital outflows. During the first two weeks in August liquid reserves fell from $2 billion to $200 million—only about three days' import cover—and by 13 August the government was forced to close the exchange market. Jesus Silva Herzog, Secretary of Finance and Public Credit, went to the United States to seek emergency aid from the US Treasury and begin discussions with the International Monetary Fund. A four-part program was set in motion, including: (1) US Government prepurchase of $1 billion worth of oil for the strategic reserves; (2) Mexican agreement to negotiate a strong economic adjustment program with the IMF; (3) US Government assistance in organizing multilateral short-term financial support from central banks and treasuries; and (4) Mexican commitment to begin talks with foreign banks on the orderly restructuring of Mexico's debt with such banks.

7. By the end of August, new US commitments totaled $2.9 billion—not including a continuing $700 million Fed swap line that was drawn down earlier in the month. In addition, other elements of the international financial community committed some $10 billion in both debt relief and new support.

8. The following figures give some idea of the dimensions of Mexico's financial straits:

— Foreign debt at more than $80 billion, with more than $30 billion to be repaid within 12 months, is the largest among developing countries.

— Debt service obligations total almost $1.6 billion each month, or about 80 percent of export earnings.

— Unless short-term debt continues to be rolled over, debt service obligations will more than double to $3.4 billion monthly.

— Despite massive devaluations, total export earnings are no more than $2 billion a month ($1.4 billion of which comes from oil sales) and are unlikely to rise much before there is a general upsurge in the world economy.

9. For the moment, the 90-day deferment on repayment of debt principal granted by the commercial banks takes some pressure off the Mexicans. Beyond the 90 days, however, Mexico City will have to come up with at least $1 billion a month in new money to meet interest payments. This underlines the importance of the IMF agreement, which is a precondition for rescheduling Mexico's foreign debt.

10. It also underscores the central importance of the attitudes of foreign private bankers, who have grown increasingly concerned since late 1981. A number of banks have adopted a deliberate policy of reducing their exposure in Mexico and may refuse to roll over loans as they come due. Despite recent successful negotiations with a number of the more important banks, any one of the more than 1,000 banks—as well as numerous individual holders of Mexican bonds—that have provided funds to the Mexican Government or private sector could raise the crisis to a new level by declaring the borrower in default and attempting to seize assets. (See tables 1 and 2.) This is more likely in Mexico than in the rest of the Third World because of the greater incidence of direct transactions by individual banks over which the financial system as a whole exerts only limited influence. An important aspect of this set of problems is already covered by the apparent willingness of major banks to exert pressure on smaller banks to avoid declarations of default.

Coping With the Crisis

11. The economic options open to the government—both internationally and domestically—will be

Table 1
Mexico: Debt Service Obligations, 1982
(Billion US $)

Amortizations	**7.5**
Public long-term	6.6
Private long-term	0.9
Interest	**12.0**
Public long-term	6.3
Private long-term	1.5
Short-term	4.2
Total	**19.5**

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Table 2
Mexico: External Debt, 30 June 1982
(Billion US $)

	Short-Term	Long-Term	Total
By Borrower			
Government and government guaranteed	12	48	60
Private	10	10	20
Total	22	58	80
By Creditor			
Commercial Banks			65
United States			25
Japan			10
Canada			6
United Kingdom			5
France			4
Other			15
Other			15
Bonds			6
Multilateral			5
Bilateral			4
Total			80

determined largely by the IMF and the international banking community. The present and future administrations will find this both distasteful and politically costly. Measures strong enough to reassure foreign bankers and domestic capitalists will inevitably go against nationalist tenets strongly held by all elements of Mexican society; strike additional blows against the already hard-hit interests of organized labor, a major component of the ruling party; undermine living standards, most notably for the middle class and for the underemployed *marginados* of the urban shantytowns and rural hamlets, the latter constituting at least 30 percent of the population; and taint incoming president de la Madrid with an "antipopular" image, possibly casting a shadow over the next six years of Mexican political life. Yet, in the absence of strong measures, the government will be seen as indecisive or inadequate to the economic task, and this would create other political as well as economic dangers.

12. The foreign banking community will demand not only action but also the appearance of action. A decision by the Mexican Government simply to hold unpublicized talks with the IMF, make private promises to major banks, or quietly apply new restrictions to labor and consumers would not be seen as satisfactory.

The Critical Issue of Timing

As Mexico City reaches for solutions to its financial crisis, we believe timing will be of the essence. Until an austerity program is in place and IMF support is assured, we expect foreign creditors to remain nervous and the Mexican financial situation precarious.

The very process of developing and negotiating a policy package will, we project, be time consuming. Mexico's success in fostering long periods of rapid economic growth without central planning and the consultative nature of its political system suggest to us that policy adjustments will be slower and more difficult for it than for most other LDCs with troubled economies.

Several important action-forcing dates face the Lopez Portillo administration as it assembles its stabilization package and sells it to the public:

15 October – Target date for agreement with the IMF.

21 November – End of 90-day standstill in commercial bank debt repayment.

1 December – New administration takes office.

In addition, there will be ongoing labor negotiations concerning the annual 1 January wage increase.

High-level public statements that the government is willing to meet foreign demands for domestic austerity would be necessary to restore international confidence. Neither outgoing President Lopez Portillo nor incoming president de la Madrid will want to be publicly associated with such measures; we expect, however, that both may be forced to take public stands before the change of administration.

13. What, precisely, will the government do? On the international trade side, Mexico City will try to boost oil and gas exports by $5 billion—to $20 billion—next year. This will require the maintenance of nominal world oil prices, some increases in production (probably in the neighborhood of 300,000 barrels per day), and a reduction in domestic consumption. We expect Mexico to be at least partially successful in these efforts, although a sharp fall in oil prices—which some analysts project—could seriously undercut this goal. Most of the impact of these measures will be felt after the period of this Estimate—beyond mid-1983.

25X1

14. Elsewhere on the international trade front, the devaluations will bring a boost to tourism and to border industry exports. Unfortunately, most other major Mexican exports are priced in dollars and will not be boosted by the devaluation in the near term. Although the use of open or hidden subsidies to boost exports will almost certainly be restricted by any agreement that Mexico reaches with the IMF, the government will come to the aid of important export industries in every way possible—most specifically through tax breaks and favorable exchange rates for private debt repayment. Imports will, of course, be restrained by the higher cost of foreign currency as well as by more direct restrictions.

15. For political as well as economic reasons, a major goal of the Mexican Government will be to reestablish a unified and stable exchange rate. The psychological cost of the recent devaluations and the imposition of exchange controls cannot be overemphasized. In the past, no economic statistic has been more politically sensitive than the peso-dollar exchange rate. To the average Mexican, government statistics on inflation, employment, and economic growth are suspect; the exchange rate, however, can be verified by the man on the street. Devaluations—which have been extremely rare—and exchange controls—which are unique to the present instance—are associated with "South America" and all the political and economic instability that that implies to the Mexican mind. Any government that fails to maintain the exchange rate and free convertibility is likely to be judged as having failed in its economic policies, no matter what other successes it achieves.

16. The "temporary" exchange controls announced in the state of the union speech on 1 September are seen by Lopez Portillo as necessary to prevent continued capital flight leading to the wholesale dollarization of the economy and are clearly measures of last resort that will have a political cost. Whatever effectiveness they have will be limited to the short term, and it is unlikely that they will be continued by de la Madrid. The new head of the Bank of Mexico, Carlos Tello, is considered a supporter of exchange controls and almost certainly will not survive the change of administration.

17. On the domestic side, the demands of the IMF and the foreign banking community will center on solid cuts in real government spending and on wage restraints. Capital spending, which has already been slashed, will be cut further. The rate of price subsidies on food, fuel, and other goods and services will be allowed to fall. The government probably will not completely eliminate subsidies on such politically sensitive items as corn, cooking oil, gasoline, and public transportation, but the nominal cost of such items may be increased to several times the present levels. While some efforts will be made to reduce federal employment, such efforts are unlikely to be long lasting, as the new administration will need to consolidate its support and co-opt its potential enemies with government jobs. Although labor will press for wage adjustments and has in prospect a substantial increase on 1 January, real wages probably will continue a downward trend throughout the period of this Estimate.

18. The nationalization of domestic banking—accompanied as it was by economically damaging but politically helpful rhetoric—may have been necessary to prevent the fall of a large number of the weaker Mexican banks. It reflects Lopez Portillo's penchant for seeking scapegoats and avoiding harsh austerity measures, and will present considerable—but not necessarily insurmountable—problems for negotiations with the IMF.

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Next 7 Page(s) In Document Denied